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EXECUTIVE SUMMARY

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Statutory pensions in Finland

Long-term projections 2007

The report presents the long-term projections of the Finnish Centre for Pensions regarding the development of statutory pension expenditure and the average pension level. Regarding the private-sector earnings-related pension acts, the report also includes a financing projection in which the main results are the development in contributions and assets under Employees Pensions Act (TyEL). This pension act covers private sector employees, approximately 60 per cent of the labour force.

Projection results presented in the body of this report are based on the existing pension legislation. However, the appendix presents two projections that differ from the current legislation. The purpose of these projections is to identify the fixed contribution level which, if implemented in 2008, would ensure the long-range financial sustainability of earnings-related pensions.

The demographic development in the baseline projection follows the latest Statistics Finland forecast up to 2040. The Finnish Center for Pensions extended this forecast beyond the year 2040. Under this extended forecast, by 2030 the life expectancy of 62-year-olds will have increased by 3.5 years (relative to its current level of 22 years), and by 2075 this life expectancy will have increased by 7 years.

The working-age population will decrease until the early 2030s, after which it will be stable. The old-age dependency ratio will increase to almost double its current level of one-fourth by the year 2030, after which the ratio will increase slowly.

The employment rate in the baseline projection is expected to rise from 69 per cent in 2006 to 71 per cent in 2025, and to 72 per cent towards the end of the projection period. The employment rate increases as the unemployment rate decreases and the effective retirement age rises. Relative to its current level, the effective retirement age is expected to increase by 2.4 years towards the end of the projection period. The expected increase in both life expectancy and the effective retirement age means that by the end of the projection period, the average time in retirement will be almost 5 years greater than it is today. In the baseline projection, the annual growth rate of the earnings level is 1.75 per cent, and the real rate of return on pension assets is 4.0 per cent per year.

The change in life expectancy of 62-year-olds has an effect on the benefit levels. If the life expectancy increases, the old-age pensions are adjusted downwards using a life expectancy coefficient. In 2025, the coefficient is expected to be 0.9, and in 2075, at the end of the projection period, the coefficient is expected to be slightly less than 0.8.

The earnings-related pension expenditure for the whole economy increases relative to the wage sum, from the current level of nearly 23 per cent to 34 per cent by 2030, after which pension expenditure decreases by 4 percentage points of the wage sum by the end of the projection period. The increase in earnings-related pension expenditure is a consequence of the growth in old-age pension expenditure. Total statutory pension expenditure currently corresponds to 11 per cent of GDP, and is projected to increase to 15 percent in the 2030s. Thereafter, the share of pension expenditure in GDP will decrease by 2 percentage points by the end of the projection period.

Over the projection period the purchasing power of the average pension almost trebles from 1,200 euros to 3,000 euros. The purchasing power of the earnings-related pension component increases as a consequence of the increase in earnings level. On the other hand, the size of the national pension component stays close to 200 euros over the whole projection period. Relative to the average wage, the average pension will increase until the beginning of the 2020s. This is explained by the maturing of the earnings-related pension scheme. After the 2020s, the relative pension level decreases. The most important reasons for this decline are the life expectancy coefficient as well as the national pension index, which increases at a slower rate than the earnings level. By the early 2030s, the ratio of the average pension to the earnings level will have returned to its current level.

The TyEL contribution rate will rise, from the current 21 percent, by 4 percentage points by the beginning of the 2030s, after which the contribution rate will be stable. By the early 2030s, the TyEL expenditure as a per cent of wage sum will increase by 12 percentage points. The TyEL assets will increase in relation to the wage sum up to the beginning of the 2030s. Currently, the assets are 1.8 times the wage sum, and, in 2030, the assets are projected to be 2.4 times the projected wage sum. Thereafter, the ratio of assets to the wage sum will not change significantly.

Under the baseline assumptions, the TyEL contribution rate will rise by four percentage points by the beginning of the 2030s. However, when all earnings-related pensions are considered, a contribution rate increase of less than one percentage point of covered earnings is sufficient to ensure the long-range financial sustainability of the scheme. In 2005, the total contributions collected to finance earnings-related pensions were 26.6 per cent of covered earnings.

The sensitivity of the baseline projection to changes in selected individual assumptions is examined in this report. Mortality changes will affect the life expectancy coefficient, and, as a consequence, will affect benefit levels. However, mortality changes will have no significant effect on pension expenditures and contribution rates. If all those who stayed in the labour market until the age of 63 continued to work until the age of 68, the foreseeable increase in earnings-related pension expenditure rate would be postponed by five years. The ultimate level of the expenditure rate does not, however, depend on the starting age of the old-age pension. Instead the average benefit level is affected by the starting age of the old-age pension.

Under the baseline assumptions, the TyEL contribution will rise by four percentage points by the beginning of the 2030s. However, if the real rate of return were five percent rather than four percent, the TyEL contribution would increase by merely one percentage point. Conversely, if the real rate of return were merely three percent, the TyEL contribution rate would increase by six percentage points.

The previous long-term report of the Finnish Centre for Pensions was published in 2004. Since that report was issued, the projected earnings-related pension expenditure rate up to the 2030s has changed only slightly. The updated projections indicate that in the long term expenditure rate as a percentage of the wage sum will be two percentage points lower than previously estimated. This difference is due to higher immigration and birth rates. The long-term TyEL contribution rate is two percentage points lower than in the previous projection. Half of this change is attributable to a change in the rate of return assumption. The remaining half is explained by other factors, including a lower long-term expenditure rate, favourable recent investment returns and new funding legislation restraining liability growth in the long term.

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